15-233, 15-255

IN THE

Supreme Court of the United States

THE COMMONWEALTH OF PUERTO RICO, *et al.*,
Petitioners,

v.

FRANKLIN CALIFORNIA TAX-FREE TRUST, *et al.*,
Respondents.

MELBA ACOSTA-FEBO, *et al.*,
Petitioners,

v.

FRANKLIN CALIFORNIA TAX-FREE TRUST, *et al.*,
Respondents.

On Writ of Certiorari
to the United States Court of Appeals
for the First Circuit

BRIEF FOR *AMICI CURIAE* PROFESSORS CLAYTON P. GILLETTE AND DAVID A. SKEEL, JR. IN SUPPORT OF PETITIONER

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INTEREST OF AMICI[1]

Professors Clayton P. Gillette and David A. Skeel, Jr. are teachers and scholars of municipal bankruptcy, bankruptcy law, and local government law. They have written extensively in the areas of municipal fiscal distress and municipal bankruptcy, including scholarship on some of the issues raised by this case. As teachers and scholars, their interest in this litigation is to promote an accurate and thorough consideration of the legal principles that deal with municipal insolvency, including the interpretation and application of the Bankruptcy Code as it applies to governments. Professor Gillette and Professor Skeel are writing in their individual capacity and their views do not necessarily represent those of the law schools with which they are affiliated.

Clayton Gillette is the Max E. Greenberg Professor of Contract Law at NYU School of Law. Professor Gillette is the author or co-author of numerous books and articles concerning local government law, including *Municipal Debt Finance Law: Theory and Practice* (2d ed. 2013); *Local Government Law: Cases and Materials* (5th ed.

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[1] All parties have consented to the filing of this brief. Professors Gillette and Skeel and their counsel are the sole authors of this brief. No party to this case or their counsel authored this brief in whole or in part, and no person other than *amici* and their counsel paid for or made a monetary contribution toward the preparation or submission of this brief.

2014); *Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy*, 79 U. Chi. L. Rev. 281 (2012); and *Bondholders and Financially Stressed Municipalities*, 39 Ford. Urb. L. J. 639 (2012).

David A. Skeel, Jr. is the S. Samuel Arsht Professor of Corporate Law at the University of Pennsylvania Law School. Professor Skeel is a member of the American College of Bankruptcy, and has served as a Scholar in Residence at the American Bankruptcy Institute. Professor Skeel is author of numerous articles on municipal bankruptcy and related issues. See, e.g., David A. Skeel, Jr., *What is a Lien? Lessons from Municipal Bankruptcy*, 2015 U. Ill. L. Rev. 675; David A. Skeel, Jr., *Is Bankruptcy the Answer for Troubled Cities and States?*, 50 Houston L. Rev. 1063 (2013); David A. Skeel, Jr., *States of Bankruptcy*, 79 U. Chi. L. Rev. 677 (2012). Professor Skeel has also testified in Congress on the question whether States should be permitted to file for bankruptcy and written on these issues in the popular media. See, e.g., David Skeel, *A Puerto Rican Solution for Illinois*, Wall St. J., Aug. 4, 2014.

Professors Gillette and Skeel have carefully studied the history of municipal bankruptcy, the details of Chapter 9, and the consequences of municipal financial distress. Their analysis of these issues will assist the Court in assessing the meaning and context of the key statutory provisions, and the consequences of interfering with Puerto Rico's exercise of its territorial police powers in enacting the Recovery Act.

SUMMARY OF ARGUMENT

By striking down the Recovery Act, the District Court took the extraordinary step of overriding Puerto Rico's exercise of its territorial police powers. If Congress clearly intended to preempt a Puerto Rican restructuring law, it had the power to do so. But there is no evidence supporting the conclusion that it did. When the predecessor of section 903(1) was enacted, Puerto Rico was deemed to be a State for municipal bankruptcy purposes and thus permitted to allow its municipalities to make use of the federal bankruptcy laws. In 1984, Congress adopted a new definition of "State" that excluded Puerto Rico's municipalities from municipal bankruptcy. There is no evidence that Congress intended for the new definition of State to leave Puerto Rico municipalities without any restructuring options.

Indeed, a literal reading of the Bankruptcy Code indicates that the pre-emptive effects of Section 903(1) cannot apply to Puerto Rico. That is because the provision prohibits the binding of "creditors," and "creditors" exist only once a petition under the Bankruptcy Code has been filed. Since Puerto Rico municipalities cannot file such petitions, the pre-emptive effect on States with respect to "creditors" is inapplicable to Puerto Rico. Moreover, the objective of Section 903, which is to preserve State autonomy and thus to shield Chapter 9 from assertions that it violates States' Tenth Amendment autonomy, has no application to Puerto Rico, which does not share States' immunity from federal intervention.

At the very least, the legislative history, the literal language, and a purposive understanding of Section 903 create ambiguity about its applicability to Puerto Rico. Under well-understood canons of construction and presumptions about pre-emption, that ambiguity should be resolved against implied pre-emption of the Recovery Act. This Court has long held that the presumption against congressional pre-emption of State authority applies equally to Puerto Rico. Canons that disfavor unreasonable interpretations lead to the same result. A finding that Congress intended Puerto Rico to have no ability – either from the Bankruptcy Code or from domestic legislation – to adjust municipal debts would jeopardize the delivery of public services, the very function that Puerto Rico municipalities were created to fulfill. The history of municipal insolvency law demonstrates attention to the need for debt adjustment in order to ensure the continued provision of municipal services without generating substantial increases in the cost of service or exit by residents. It is, therefore, implausible that Congress, by denying Puerto Rico's municipalities access to Chapter 9, intended that they have no avenue by which to adjust their debts.

The First Circuit's response that Puerto Rico has recourse to Congress not only reverses the presumption against pre-emption, but also fails to consider that, unlike States, Puerto Rico does not have direct representation in Congress that permits it to bargain for legislation that protects its interests. Nor are the interests of Puerto Rico in obtaining debt

adjustment legislation aligned with those of States, which are represented in Congress but that already possess federal authority to allow their municipalities to adjust debts in federal bankruptcy proceedings.

Given the long-settled rule against preemption of State or territorial legislation unless the preemption is unmistakably clear, and the absence of clear preemption here, this Court should reverse the judgment invalidating the Recovery Act.

ARGUMENT

I. Section 903 Was Not Intended to, and Does Not, Pre-empt Puerto Rico Legislation such as the Recovery Act.

Although Congress's reasons for excluding Puerto Rico municipalities from Chapter 9 as of 1984 are not clear, there is substantial evidence that Congress did not intend to pre-empt Puerto Rico legislation such as the Recovery Act, and no evidence at all that Congress sought to leave Puerto Rico without any restructuring option. In the discussion that follows, we begin by briefly reviewing the history of the key provisions: section 903, which restricts the right of states to enact state municipal restructuring laws; and section 101(52), which defines "State" in a manner that excludes Puerto Rico's municipalities from Chapter 9. We then focus more carefully on section 903, and demonstrate how both its literal language and its context reveal that the provision simply does not apply to Puerto Rico.

We conclude by explaining more fully the structural concerns that animate section 903, and why this provision is designed to apply only to states.

A. The History of Section 903 and the Definition of "State."

From the earliest municipal bankruptcy laws until 1984, Puerto Rico municipalities were authorized to file for municipal bankruptcy. The first municipal bankruptcy law, which was enacted in 1934 as amendments to the Bankruptcy Act of 1898 and which the Supreme Court invalidated in 1936, authorized "[a]ny municipality or other political subdivision of any State" to file for municipal bankruptcy. Act of May 24, 1934, 73rd Cong., 2d Sess., § 80, 48 Stat. 798 (1934). The Bankruptcy Act defined "State" to include territories such as Puerto Rico. The 1937 municipal bankruptcy statute, which the Supreme Court upheld in 1938, simply listed the types of municipalities that could file for bankruptcy, including "any city, town, village, borough, township, or other municipality." Act of Aug. 16, 1937, Pub. L. No. 75-302, § 81, 51 Stat. 653 (1937). These municipal bankruptcy provisions, which governed until Congress enacted the current Bankruptcy Code in 1978, clearly encompassed municipalities in Puerto Rico as well as municipalities in the States.

In 1942, the Supreme Court upheld a New Jersey State law restructuring framework in *Faitoute Iron & Steel Co. v. City of Asbury Park*, 316 U.S. 502 (1942). The Court held that the statute did

not offend the Contract Clause prohibition against State impairment of contracts because it improved the likely recovery of the bonds that would be restructured and came in response to a financial emergency. After the *Faitoute* decision, a State or territory had two different restructuring options for its municipalities: If permitted by the State or territory, a fiscally distressed municipality could file for bankruptcy in Chapter IX, the predecessor to current Chapter 9, or the State or territory could enact its own restructuring statute.

In 1946, Congress amended the Bankruptcy Act to restrict State laws that facilitate restructuring by "composition" of municipal debt. The 1946 amendments appear to have been based on a set of proposals made by the American Bar Association. Both the House and Senate Reports, like the ABA proposals, described section 83(i), the predecessor to current section 903, as designed to ensure that a single, federal bankruptcy law would govern all municipal debt adjustments where municipalities were eligible to participate in the federal bankruptcy regime. H.R. Rep. No. 2246, 79th Cong., 2d Sess. 4 (1946). As discussed below, the scope of section 83(i) and of its successor, section 903 of the current Bankruptcy Code, is debatable, given the tension between the provision Congress enacted and the drafters' apparent intent. What is absolutely clear is that Puerto Rico had at least one restructuring option—municipal bankruptcy— at all times.

The other key development came in 1984, when Congress enacted a new definition of "State" as

part of a set of bankruptcy reforms that that were largely concerned with more pressing issues such as the constitutionality of bankruptcy's judicial and administrative structure. As originally enacted, the 1978 Bankruptcy Code, which had replaced the prior Bankruptcy Act, did not include a definition for "State." In 1984, Congress added a new provision defining "State" as "includ[ing] the District of Columbia and Puerto Rico, except for the purpose of who may be a debtor under chapter 9 of this title." 11 U.S.C. § 101(52). It is not clear why Congress excluded the District of Columbia and Puerto Rico from Chapter 9. Indeed, almost the only reference to the new definition in the legislative history came in testimony by Professor Frank Kennedy, one of the leading bankruptcy scholars of the era and executive director of the Commission on Bankruptcy Laws, who stated: "I do not understand why the municipal corporations of Puerto Rico are denied by the proposed definition of 'State' of the right to seek relief under Chapter 9, but the addition of the definition of 'State' is useful." Bankruptcy Improvements Act, Hearing on S. 333 & S. 445, before the Senate Comm. on the Judiciary, 98th Cong., 1st Sess. (April 6, 1983).

Whatever the rationale for excluding Puerto Rico from Chapter 9, the First Circuit's conclusion that section 903 precludes Puerto Rico from enacting its own restructuring law cannot be justified under either a literal or a more purposive interpretation of section 903.

B. Section 903 Does Not Apply to Puerto Rico.

Section 903 states:

> **Reservation of State power to control municipalities**
>
> This chapter does not limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of such municipality, including expenditures for such exercise, but—
>
> (1) a State law prescribing a method of composition of indebtedness of such municipality may not bind any creditor that does not consent to such composition; and
>
> (2) a judgment entered under such a law may not bind a creditor that does not consent to such composition.

The First Circuit interpreted section 903 as precluding Puerto Rico from using its police power to enact a restructuring law such as the Recovery Act. According to the First Circuit, section 903 is a blanket prohibition invalidating every "State" municipal restructuring law; since Puerto Rico is defined as a State for every purpose in the bankruptcy laws except for determining which municipalities can file for Chapter 9, the blanket prohibition extends to Puerto Rico.

Even if we ignored the implications of this conclusion—which would prohibit Puerto Rico from making use of its basic police powers to address municipal fiscal distress—it cannot be reconciled either with the literal language or a more holistic interpretation of section 903; and it extends section 903 to a context for which it was never intended.

1. The language and context of Section 903.

We start, as numerous decisions of this Court instruct, with the literal language. See, e.g., *Hartford Underwriters Insurance Co. v. Union Planters Bank*, 530 U.S. 1, 6 (2000). Under section 903(1), a composition law "may not bind any creditor that does not consent," and section 903(2) says that "a judgment entered under such a law may not bind a creditor that does not consent to such composition." The key term here is "creditor," which is carefully defined by the Bankruptcy Code. A "creditor" is "an entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor," 11 U.S.C. § 101(10)(A), or an entity that has a claim under a handful of other sections of the Bankruptcy Code not relevant here. 11 U.S.C. § 101(10)(B), (C). As this definition makes quite clear, "creditors" do not exist until a debtor has actually filed a bankruptcy case. The term "debtor" is defined quite similarly. Under 11 U.S.C. § 101(13), "[t]he term 'debtor' means person or municipality concerning which a case under this title has been commenced." By its literal terms, section 903

therefore does not apply unless a Chapter 9 case has actually been filed.[2]

Sidestepping the literal language, the First Circuit construed section 903 as a blanket ban on compositions, based on legislative history stating that "[o]nly under a Federal law should a creditor be forced to accept such an adjustment without his consent.'" *Franklin California Tax-Free Trust v. Puerto Rico*, 805 F.3d 322, 335 (1st Cir. 2015) (emphasis removed). The First Circuit concluded that section 903 was intended to ban all non-federal municipal restructuring laws, even in the absence of a pending Chapter 9 proceeding. The court ignored the technical definitions of "creditor" and "debtor," and used the "ordinary meaning" of "creditor" to achieve what the court mistakenly believed to be the "express purpose" of section 903(1). *Id.* at 340.[3]

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[2] In its brief opposing certiorari, one respondent argues that the definition of "creditor" was broader when section 83(i) was enacted. *Franklin* Cert. Op. 18. Chapter IX defined creditor as "the holder of security or securities," and "security" as "bonds, notes, judgments claims, and demands, liquidated or unliquidated, and other evidences of indebtedness." Act of July 1, 1946, ch. 532, § 82, 60 Stat. 409, 410 (1946). But even in 1946, this definition appears to have been understood as limited to "securities" of an actual Chapter IX debtor. And in 1976, Congress removed any doubt, explicitly defining "creditor" as "holder . . . of a claim against the petitioner." Act to Amend Chapter IX of the Bankruptcy Act, Pub. L. No. 94-260, § 81(3), (8) 90 Stat. 315 (1976). The 1978 Code then adopted the current definition of creditor.

[3] To justify its disregard of the definitions, the First Circuit strained to find examples of provisions that use the term "creditor" more broadly than the literal definition. The

If the technical definitions of "creditor" and "debtor" were the only basis for concluding that section 903 is a more limited ban, the First Circuit's conclusion would be questionable, but plausible. But the context strongly reinforces the literal reading. If section 903 were intended to create an absolute ban on non-federal municipal restructuring laws, it comes in an odd place. One would expect a blanket ban to stand apart from Chapter 9, as a separate provision. This is how Congress has handled bankruptcy crimes, see, e.g., 18 U.S.C. § 152 (concealment of assets), litigation against trustees and receivers, 28 U.S.C. § 959, and many other issues. But section 903 occurs in the heart of Chapter 9, where one would expect to find provisions that apply in the context of an actual Chapter 9 case.

Contrary to the First Circuit's suggestion that a narrower interpretation of section 903 is "novel," bankruptcy experts have puzzled over this feature of section 903(1) for some time. Given the literal language of the provision, and the context in which the provision appears, it does not seem to constitute a blanket ban. In an article published several years before the current solvency crisis in Puerto Rico, a bankruptcy lawyer who is involved in this case stated that section 903(1) "appears as an exception to section 903's respect for state law in chapter 9 and

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most striking feature of the First Circuit's three examples, set forth at 805 F.3d n. 28, is that each is only likely to come into play in an actual bankruptcy case. Lawmakers clearly used the term quite carefully, as is evident throughout the Bankruptcy Code.

thus appears to apply only in a chapter 9 bankruptcy. It is not clear how it would apply if no chapter 9 case was commenced." Thomas Moers Mayer, *State Sovereignty, State Bankruptcy, and a Reconsideration of Chapter 9*, 85 Am. Bankr. L.J. 363, 379 n. 84 (2011).

One of us made a very similar point, also in an article published before the current crisis, writing (based in part on conversations with other bankruptcy scholars) that section 903 "invalidates ... 'composition' provisions in Chapter 9. Whether this Chapter 9 provision would have a preclusive effect even outside Chapter 9 is not altogether clear." David A. Skeel, Jr., States of Bankruptcy, 79 U. CHI. L. REV. 677, 730 n. 230 (2012).

Nor is this interpretation of section 903 in any way nonsensical or unworkable. To the contrary, this is precisely how bankruptcy law functions for private businesses. Although financial distress is sometimes addressed under state procedures such as an assignment for the benefit of creditors, bankruptcy supersedes them if a bankruptcy case is filed. Under section 303(h)(2), for instance, the existence of a State law proceeding that has taken control of the debtor's assets serves as a validation of an involuntary bankruptcy case, which then supersedes the State law proceeding. In the municipal context, Chapter 9 might supersede any provision in a state statute dealing with distressed municipalities that functioned as a composition provision.

Two further points warrant mention. First, it is important to recognize that a non-federal insolvency framework would not be the same as Chapter 9. A non-federal alternative in Puerto Rico or elsewhere would still have to satisfy the conditions, such as remedying a broad and general social or economic problem, that sometimes exempt state impairment of debts from invalidation under the Contracts Clause of the state, territory and United States constitutions. A non-federal insolvency framework thus would have a more limited scope than Chapter 9. See, e.g., *Energy Reserves Grp., Inc. v. Kansas Power & Light Co.*, 459 U.S. 400, 410–13 (1983); *United States Trust Co. v. New Jersey*, 431 U.S. 1 (1977); *Home Building & Loan Assn. v. Blaisdell*, 290 U.S. 398 (1934). The First Circuit seems to have mistakenly thought that a non-federal municipal restructuring law would simply be a substitute for Chapter 9.

Second, there are serious questions whether a blanket ban would constitute an unconstitutional interference with states' police powers. During the New York City crisis of the 1970s, for instance, a federal district court stated in dicta that "[a] federal court decision that the federal Bankruptcy Act precludes the New York State legislature from implementing [an] emergency measure aimed at dealing with a fiscal crisis of unprecedented proportions affecting its largest city would raise very serious questions about the right of a state effectively to govern its political subdivisions." *Ropico v. City of New York*, 425 F. Supp. 970, 983-84 (S.D.N.Y. 1976).

A leading bankruptcy treatise also points out the constitutional concerns, stating that:

> If a state composition procedure does not run afoul of the contracts clause, then municipal financial arrangement under a state procedure should be a permissible exercise of state power, and a congressional enactment prohibiting that exercise would be a congressional overreaching in violation of the Tenth Amendment.

6 Collier on Bankruptcy para. 903.03 [2] (A.N. Resnick & Henry J. Sommer, eds., 16th ed. 2015). This Court does not need to resolve the constitutional issue, since Puerto Rico does not have the same sovereignty as a state, but it further underscores what a minefield the First Circuit's interpretation of section 903 is.

2. Lawmakers were concerned with States, not with Puerto Rico.

The flaws in the First Circuit's interpretation are even more apparent when one considers the objectives that Congress had in mind when it enacted Section 903. These objectives reveal even more clearly that Congress did not intend that provision to apply to Puerto Rico. When Congress enacted the predecessor of section 903 in 1946, lawmakers were concerned to promote uniform municipal bankruptcy procedures among the States. There is no evidence that lawmakers were thinking about Puerto Rico or other territories at all. In the House Report, for

instance, lawmakers stated that "a bankruptcy law under which the bondholders of a municipality are required to surrender or cancel their obligations should be uniform throughout the 48 states." H.R. Rep. No. 2246, 79th Cong., 2d Sess. 4 (1946). Although the technical definition of "State" included Puerto Rico under the bankruptcy law in place at this time, lawmakers' express purpose—which was the yardstick used by the First Circuit-- was to assure uniformity among the actual States, not uniformity among the States and territories. Congress's decision to exclude Puerto Rico municipalities from Chapter 9 in 1984 underscored this distinction. As of 1984, Chapter 9 explicitly distinguished between Puerto Rico and the fifty States. However one interprets section 903 as it applies to the States, it has no application to Puerto Rico.

The distinction, of course, is perfectly reasonable. Congress could determine that the reasons for imposing uniformity on States were, in the case of territories, subordinated to the desire to provide the latter with a degree of autonomy consistent with their status. Indeed, this Court has recognized both the propriety and legality of congressional enactments that distinguish between Puerto Rico and the States. See, e.g., *Harris v. Rosario*, 446 U.S. 651, 651-52 (1980) (per curiam) (upholding differential assistance to Puerto Rico and the States under Aid to Families with Dependent Children because, under the Territory Clause of the Constitution, U.S. Const., Art. IV, § 3, cl. 2, Congress

"may treat Puerto Rico differently from States so long as there is a rational basis for its actions." If Congress can treat Puerto Rico less favorably than it treats the States, there is little reason to believe that it could not treat Puerto Rico more favorably by allowing greater flexibility with respect to resolving municipal distress than the States enjoy.

Congressional concern with States – and not Puerto Rico – is apparent from the role that Section 903 plays in ensuring the constitutionality of Chapter 9. Begin with the language of Section 903 itself. The caption to Section 903 reads: "Reservation of State power to control municipalities."[4] The operative language of the Section, to which subsection 903(1) is a proviso, states that "[t]his chapter" does not limit or impair the power of a "State" to control its municipalities. The statutory language thus indicates that the explicit objective of Section 903 is to preserve the rights of "States" with respect to their municipalities notwithstanding "[t]his chapter," i.e., notwithstanding Chapter 9's creation of a bankruptcy scheme for a State's municipalities. Section 903, therefore, retains for States the plenary authority that they exercise over their municipalities and that one might otherwise contend Congress had assigned to federal bankruptcy courts in Chapter 9 proceedings. The preservation of States' plenary authority *notwithstanding* municipal

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[4] The captions to Section in the Bankruptcy Act were within the congressionally-enacted statute and were not simply added during the codification process. See Bankruptcy Reform Act of 1978, Pub. L. 95–598, 92 Stat. 2549 (1978).

bankruptcy is, however, meaningless where Congress has not purported to permit federal municipal bankruptcy in the first instance. Since Puerto Rico municipalities have no access to Chapter 9, the stated reservation of plenary power plays no role, and the proviso that is predicated on that reservation has no application.

Perhaps more to the point, the limited application of Section 903 makes sense because its inclusion was intended to address an issue inapposite to Puerto Rico. Both courts and commentators have recognized that the reservation of States' authority over their political subdivisions was incorporated into the Bankruptcy Code to avoid any claim that Congress had exceeded its constitutional authority by enacting a process for municipal debt adjustment. See Collier on Bankruptcy, supra, at ¶ 903.02[2] ("The purpose of [section 903] is to remove any inference that the legislation itself accomplishes anything more than providing a procedure under which municipalities may adjust their indebtedness. The structure and the substance of chapter 9 belie any attempt by Congress to interfere with a state's control over its municipalities"); In re *Vallejo*, 403 B.R. 72, 75 (Bankr. E.D. Cal. 2009) ("Section 903 ensures the constitutionality of chapter 9. . . .") *In re County of Orange*, 179 B.R. 177, 181 n.10 (Bankr. C.D. Cal. 1995) ("The legislative history of Chapter 9 indicates that § 903 was crucial to the constitutionality of Chapter 9."); *In re Jefferson County*, 474 B.R. 228, 276 (Bankr. N.D. Ala. 2012) ("Both §§ 903, 904 have

been carried forward from the prior bankruptcy statute as part of what Congress did to overcome the Supreme Court's . . . rationale for striking down the 1934 enacted municipal bankruptcy provisions. . . . [B]oth §§ 903, 904 are designed to recognize the sovereignty of states").

The premise of § 903 as a shield for State autonomy, free from congressional intrusion, however, does not apply to Puerto Rico, for the simple reason that – as the First Circuit held – Puerto Rico does not enjoy the same Tenth Amendment autonomy from congressional intervention as the States. *Franklin California Tax-Free Trust*, 805 F.3d at 344-45. Regardless of the degree of autonomy that Congress has granted to Puerto Rico over its own affairs, as a constitutional matter, Congress may exercise authority over a territory that it cannot exercise over States. Section 903's objective of averting any claim of unconstitutional federal intrusions into powers reserved to the States, therefore, plays no role in the relationship between Congress and an entity, such as the Commonwealth, that has no Tenth Amendment immunity.

The First Circuit did not address these arguments. Instead, it concluded that section 83, the predecessor to section 903, was predicated on a belief that only a Federal law should force a creditor to take an adjustment. See 805 F.3d at 335. The First Circuit justified this conclusion on the basis that it was necessary in order to promote uniformity in the

imposition of nonconsensual adjustments on municipal creditors. *Id.*

The need for uniformity might make sense where federal law actually provides for municipal bankruptcy proceedings. It could be problematic to have Chapter 9 apply in some cases when it is available, but not in other cases when it is available. But all agree that Chapter 9 does not apply to Puerto Rico at all. Instead, Puerto Rico is treated differently from the States with respect to debt adjustment. Hence, there is no uniformity between the States and Puerto Rico about debt adjustment. Thus, the uniformity rationale for 903(1), which makes sense where Chapter 9 is available, has no application to debt adjustment in Puerto Rico, where it is not.

The First Circuit similarly concluded that the need for uniformity suggests that there is conflict preemption: "all of the relevant authority shows that Congress quite plainly wanted a single federal law to be the sole source of authority if municipal bondholders were to have their rights altered without their consent." 805 F.3d at 343. But the failure to include Puerto Rico municipalities within Chapter 9 again denies the First Circuit's premise of uniform treatment, since holders of Puerto Rico municipal bonds are, by hypothesis, treated in a nonuniform manner relative to holders of municipal bonds issued by municipalities of States that have access to Chapter 9.

II. Ambiguity Concerning Congressional Intent Should Be Resolved Against the Unreasonable Result of Prohibiting Debt Adjustment that Assures Provision of Vital Municipal Services.

A. The Failure to Allow Debt Adjustment Drastically Diminishes the Capacity of Municipalities to Fulfill Their Role as Providers of Public Goods.

We have demonstrated above that careful analysis of the relevant statutes and legislative history reveals that Congress did not, by excluding Puerto Rico municipalities from the category of eligible "debtors" under Chapter 9, intend to pre-empt Puerto Rico from creating its own mechanism for adjusting the debts of distressed municipalities. At the very least, the above analysis demonstrates ambiguity concerning congressional intent. Any such ambiguity should be resolved by the application of well-established canons of interpretation, including a presumption against federal pre-emption and against constructions that are unreasonable or absurd.

The First Circuit's analysis of the issue paid insufficient deference to those canons. It assigned at most a "weak" presumption against pre-emption, 805 F.3d at 341, and purported to investigate congressional intent purely from an unfettered analysis of statutory language, purpose, history, and the surrounding statutory scheme. *Id.* at 334. That approach ignores this Court's precedents that demand a clearer statement of congressional intent to pre-empt state or territorial law and thus

implicitly create a presumption against pre-emption. See, e.g., *Arizona v. United States*, 132 S.Ct. 2492, 2501 (2012); *Puerto Rico Dept. of Consumer Affairs v. Isla Petroleum Corp.*, 485 U.S. 495, 503 (1988) ("a "clear and manifest purpose" of pre-emption is always required"). This Court has concluded that the test for federal pre-emption of the law of Puerto Rico is the same as the test for pre-emption of the law of a State. *Puerto Rico Dept. of Consumer Affairs v. Isla Petroleum Corp.*, 485 U.S. 495, 499 (1988). While inattention to the requirement of a clear statement rule may be harmless error where congressional intent as reflected in the statutory language, purpose, or history is uncontested, that cannot be the case where, as here, the application of Section 903 to Puerto Rico is at least ambiguous.

Moreover, canons of interpretation require courts to interpret statutes to avoid unreasonable, unequitable, or even odd results. *See, e.g., Comm'r v. Asphalt Prods. Co.*, 482 U.S. 117 (1987); *Hughey v. JMS Dev. Corp.*, 78 F.3d 1523, 1529 (11th Cir.1996) (quoting *Green v. Bock Laundry Mach. Co.*, 490 U.S. 504, 509 (1989)). A construction of Section 903(1) that pre-empts Puerto Rico's capacity to adjust debts is unreasonable because, by denying Puerto Rico any capacity to adjust onerous debt, it fully subordinates the interests of residents of insolvent Puerto Rico municipalities to those of creditors and thus deprives those residents of access to essential services that cannot be obtained elsewhere. The result is that insolvent municipalities are financially precluded from fulfilling the very public functions that underlie

their creation. A construction that leads to that result is all the more unreasonable because it contradicts the core function of municipal bankruptcy – the protection of vital municipal services from depletion by creditors.

Municipal corporations, such as the municipalities covered by the Recovery Act, play a unique role in the provision of services. As is the case with private firms, municipal corporations provide goods and services to "customers" (residents). But the goods and services that municipal corporations provide differ from the goods and services provided by private firms operating in a well-functioning market. The goods and services provided by municipal corporations, such as police, fire, and utilities, involve "public goods" or goods that have characteristics of "natural monopolies." The latter category involves goods that have continually decreasing average costs – "the greater the level of output, the lower the cost per unit." Harvey S. Rosen and Ted Gayer, *Public Finance* 358 (9th ed. 2010). Typically this occurs when the initial capital costs of entry are so high that a potential private producer of the good would forebear from incurring them without some assurance of monopoly provision, because the producer cannot be confident that it will recover its initial investment if another entrant provides a similar service.

Goods and services are "public" when they have characteristics that deter private firms from supplying them, notwithstanding that there is substantial demand for them. Goods have

characteristics of "publicness" if they are "nonrival," in the sense that multiple consumers – even those who contribute nothing to their cost of production – can utilize them simultaneously once they are produced. As a result, potential consumers will wait for another consumer to incur the cost of production and then "free ride" off that consumer's effort. Potential private providers of such goods will fail to produce at an efficient level because they recognize that potential consumers will not pay for a service that can be obtained for "free" if someone else incurs the cost. Or, public goods may be "nonexcludable," in the sense that it would be inefficient to attempt to recover from users the minimal marginal cost of providing the good. *Id.* at 54-56.

Where goods are susceptible to natural monopoly or have characteristics of public goods, governmental provision is necessary or appropriate because the inability of private actors to recapture their investment deters them from entering the market. Where the goods or services at issue have limited geographical scope (e.g., policing, utilities, rather than national defense) a local government typically provides the goods and imposes mandatory taxes or fees to pay for them. More important for present purposes, provision of public goods is arguably the most important function of municipal corporations because, given market failures, the absence of a public substitute means that the services simply will not exist at an efficient level.

The vital role of local governments in providing public goods, therefore, means that the

fiscal incapacity of a municipality to perform its functions has dire consequences not present when a private firm fails in a competitive market. A distressed private firm that cannot adjust its debts may have to liquidate, but its customers continue to satisfy their needs through marketplace transactions with the failed firm's competitors. But the "customers" (residents) of a distressed municipality have no such option. Residents who cannot obtain goods and services from their local governments at something close to marginal cost must either move to a different jurisdiction, pay inordinately high prices (taxes and fees) for services, or do without. Obviously, this has distributive effects as firms and residents able to do so leave the jurisdiction to escape higher taxes and fees, leaving the municipality with a smaller and smaller tax base to provide services to a poorer population, and a larger share of municipal revenues is used to pay for past debts rather than to pay for current services or to make productive investments that might attract a higher tax base. *See, e.g., In re Sullivan Cnty. Reg'l Refuse Disposal Dist.*, 165 B.R. 60, 66 (Bankr. D.N.H. 1994) (discussing how a disposal district's tipping fees led to a "'death spiral' . . . whereby increased fees result in lower total dollar collections by driving away customers because of the higher fees"); *In re Pub. Serv. Co. of N.H.*, 114 B.R. 820, 831 (Bankr. D.N.H. 1990) (discussing how electricity rates set "too high" can trigger a "death spiral" of diminishing returns due to an exodus of customers).

Congress and the courts have recognized this unique role of municipalities and have required creditors to accept debt adjustment in order to ensure the efficient provision of services to residents through the enactment and implementation of Chapter 9. Implicitly, the enactment of Chapter 9 recognizes that creditors are in a far superior position to bear the risk of municipal fiscal distress than are residents, because creditors can spread the risk of default over a diversified portfolio of investments, while residents have no alternative source of service. This balance of interests pervades Chapter 9. Thus, bankruptcy courts have interpreted the requirement that a municipality be "insolvent" before filing a petition under Chapter 9 to mean "service delivery insolvency." *See* In re *City of Stockton*, 493 B.R. 772, 781 (Bankr. E.D. Cal. 2013); In re *City of Detroit*, 504 B.R. 97, 169-70 (Bankr. E.D. Mich. 2013). A proposed plan to exit Chapter 9 can be confirmed only if it is "feasible," 11 U.S.C. § 943(b)(7), and courts have interpreted feasibility to mean "whether the debtor can accomplish what the plan proposes and provide governmental services." In re *Mount Carbon Metro. Dist.*, 242 B.R. 18, 35 (Bankr. D. Colo.1999). Notably, the court in the City of Detroit bankruptcy recently adopted a standard of "feasibility" that considered whether the city "will be able to sustainably provide basic municipal services to the citizens of Detroit and to meet the obligations contemplated in the Plan without the significant probability of a default." In re *City of Detroit*, 524 B.R. 147, 222 (Bankr. E.D. Mich. 2014). Indeed, the entire structure of Chapter 9 is commonly recognized

as providing a municipality with a "fresh start," analogous to an individual bankruptcy, rather than a mechanism purely for the collection of assets to maximize the benefit of creditors, as in the case of corporate bankruptcy. *See* Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. Chi. L. Rev. 425, 470 (1993) ("[M]unicipal bankruptcy is based on the idea of the fresh start rather than the efficient reconfiguration of assets. The theory of Chapter 9 is that the burden of debt service, if sufficiently high, will affect the taxpayers of a city as it would a debt-ridden individual: it will sap initiative and depress money-generating activity"); Omer Kimhi, *Reviving Cities: Legal Remedies to Municipal Fiscal Crises*, 88 B.U. L. Rev. 633, 654 (2008) ("The underlying assumption [of municipal bankruptcy] is that mitigating the city's financial hardship provides the locality with a fresh start and enables its rehabilitation, to the benefit of both residents and creditors.").

Even outside of municipal bankruptcy, courts have long recognized that the crucial role of municipalities in providing public goods requires creditors to bear some risk of fiscal distress. Justice Frankfurter noted in *Faitoute Iron & Steel Co. v. City of Asbury Park*, 316 U.S. 502, 510 (1942), that failure to adjust debts had generated an "empty right to litigate," as creditors armed with a writ of mandamus to collect taxes from an insolvent municipality were met with resignations of tax-collecting officers, and courts systematically refused

to force municipalities to pay where the result was the further deterioration of municipal services. *See* Robert S. Amdursky, Clayton P. Gillette, & G. Allen Bass, *Municipal Debt Finance Law: Theory and Practice* 334-38 (2d ed. 2013) (discussing the reluctance by courts to order a remedy that would push insolvent municipalities further into fiscal distress). Even courts that agreed that creditors of a municipality were entitled to a writ of mandamus to collect taxes sufficient to pay debts ultimately observed that if payment would prevent the debtor from performing its "essential functions" the writ would not issue. *See, e.g., Cromartie v. Commr's of Bladen*, 85 N.C. 211, 216 (1881) ("[I]f the entire fund which can be raised by taxation is required to meet the necessary expenses of an economical administration of the county government, and none can be diverted to pay its indebtedness without serious detriment to the public, none ought to be thus appropriated"); *Defoe v. Town of Rutherfordton*, 122 F.2d 342, 345 (4th Cir. 1941) ("We agree that the court may modify an order in the nature of a writ of mandamus, where in the light of subsequent events its commands have become improper, as where . . . [it] would interfere with the support of necessary governmental functions."). Alternatively, courts effectively compromised debts by structuring the terms of payment in a manner that balanced "the orderly administration of municipal government and the duty owing to the [creditor]." *United States ex rel. Metzger v. City of Vero Beach*, 90 F.2d 70, 72 (5th Cir. 1937).

Congress certainly was aware of this history when it enacted the predecessor to section 903 in 1946. *See* McConnell & Picker, *supra* at 462 (describing the legislative underpinnings of the predecessor of section 903). The creation of a federal bankruptcy law eliminated both the need for uncoordinated, case-by-case adjudication of municipal circumstances and the frustration of potentially conflicting State procedures. But given that Congress was reacting to the need to bring order to the process of debt adjustment, rather than to forestall or limit it, it would be unreasonable to believe that Congress was doing anything more than substituting a federal bankruptcy remedy for a State-provided one that assured the continued provision of municipal services to residents who would otherwise have no avenue for obtaining them.

The negative implication of that congressional intervention, however, is that where no federal bankruptcy has been made available, as in the case of Puerto Rico, the traditional ability of the State or territory to restructure the debt of its municipalities must be deemed to remain intact, lest the consequences that bankruptcy averts are allowed to materialize. In short, debt adjustment for municipalities recognizes the central role that they play in efficiently providing public goods and services not otherwise available in the market and ensures the continued availability of those services while minimizing the effects on creditors. Of course, Contracts Clause jurisprudence ensures that those adverse effects on creditors will be reasonable,

consistent with the continued provision of public services. *Energy Reserves Grp., Inc. v. Kansas Power & Light Co.*, supra, 459 U.S. at 413.

Puerto Rico municipalities today face the very consequences of debt overhang that Congress sought to avoid. A 2014 report from the Federal Reserve Bank of New York ("Report") illustrates that the "death spiral" of high rates of exit followed by high taxes and fees for those who remain followed by higher rates of exit has indeed materialized. *See generally* Federal Reserve Bank of New York, *An Update on the Competitiveness of Puerto Rico's Economy* (July 31, 2014), *available at* http://newyorkfed.org/outreach-and-education/puerto-rico/2014/Puerto-Rico-Report-2014.pdf (last visited January 20, 2016). That Report concluded that "[a]mong the fifty states plus the District of Columbia, Puerto Rico would rank second in terms of total tax burden, behind only Alaska with its unusually large severance taxes." *Id.* at 14. One consequence of this has been sustained depopulation. Puerto Rico has suffered a significant and accelerating population decline, from a peak of 3.8 million in 2004 to about 3.6 million in 2013, a decline of 212,000 residents, or 5.5 percent – a population decline that is among the steepest among countries around the world. *Id.* at 4 (footnotes omitted). Puerto Rico's debt-to-income ratio exceeds 100 percent, a figure well in excess of the maximum 60 percent figure that the European Union's Stability and Growth Pact requires for its members. *Id.* at 5.

It is improbable that Congress, by denying Puerto Rico's municipalities access to Chapter 9, intended that they have no avenue by which to adjust debts and thus would be required to devote resources to creditors without consideration of the effects on residents who had no options for alternative services. To believe that Congress desired to deny Puerto Rico's municipalities relief is to entertain the implausible conclusion that Congress either was indifferent to the plight of Puerto Rico's municipalities, thereby locking them into service delivery insolvency with its inherent death spiral, or that Congress preferred to grant creditors of Puerto Rico's municipalities an entitlement that is available in no other jurisdiction and that would inevitably recreate the hapless "empty right to litigate" that mandatory debt adjustment avoids.

B. The Technical Ability of Puerto Rico to Seek Recourse From Congress Does Not Preclude the Recovery Act.

The First Circuit's response to the dire consequences that result from the unavailability of both Chapter 9 and a Commonwealth alternative was to observe that recourse can be had in Congress, indeed a. benevolent Congress: "Accordingly, Congress may wish to adopt other -- and possibly better -- options to address the insolvency of Puerto Rico municipalities that are not available to it when addressing similar problems in the states." 805 F.3d at 337.

Certainly Congress could fashion a bankruptcy scheme for Puerto Rico's municipalities or include them within Chapter 9. But Congress would have to do so, and there is little reason, absent an express statement of pre-emption, to believe that Congress intended to allow Puerto Rico municipalities to risk service delivery insolvency and the denial of services to residents until it decided to act. Indeed, the standard rationale for preferring redress through Congress over judicial intervention does not apply here. In the standard case, the party seeking federal action or clarification of statutory rights has the capacity to induce Congress to act as a constituent in the representative process. See *Garcia v. San Antonio Metropolitan Transit Authority*, 469 U.S. 528, 552 (1985) (indicating how state representation in the federal legislature protects state sovereign interests). Puerto Rico, however, does not share the political access to or direct representation in Congress that is available to a State and its constituents. The Delegate from Puerto Rico currently has no vote on the floor of Congress. While there have been times when delegates were permitted to vote when the House met as a Committee of the Whole, the effect of those votes was avoided where they were "decisive," that is, where the result of the vote would have changed without the votes of delegates. In that event, House rules provided that the Committee of the Whole would immediately rise and the House itself, absent the votes of delegates, would vote on the question.[5] The

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[5] Christopher M. Davis, Delegates to the U.S. Congress:

Delegate from Puerto Rico may speak in Congress, but can offer nothing to induce those who decide an issue of interest to Puerto Rico to listen. Puerto Rico does not have representatives who can influence the legislative process by forming or joining a voting coalition, engaging in the normal process of vote trading and compromise, or even offering motions to reconsider a vote during floor debate.

In the current case, the First Circuit's reliance on recourse to Congress is additionally misplaced because Puerto Rico cannot even rely on an affinity with the States to ensure that Puerto Rico's interests are represented in the legislative process. Where Congress treats Puerto Rico in a manner identical to the way it treats the States, the absence of direct representation may not preclude a full airing of the interests that Puerto Rico has in federal action or inaction. See, e.g., 28 U.S.C. § 1332(e) (Puerto Rico to be treated as a "state" for purposes of diversity jurisdiction); 18 U.S.C. §§ 2510–2520 (Title III of Omnibus Crime Control and Safe Streets Act of 1968 applies to Puerto Rico); *Camacho v. Autoridad de Telefonos de Puerto Rico*, 868 F.2d 482 (1st Cir. 1989) (same). With respect to the ability to adjust municipal debts, however, Chapter 9 gives Puerto Rico treatment different from and less generous than the treatment accorded to States. Once Puerto Rico municipalities fall into fiscal distress, States that already have recourse to Chapter 9 for their

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History and Current Status, Congressional Research Service (August 25, 2015), available at https://www.fas.org/sgp/crs/misc/R40555.pdf.

municipalities have no incentive to give Puerto Rico similar authority. Even those States that have not yet enacted the requisite "specific authorization" for their municipalities to file Chapter 9 petitions do not have interests that align with those of Puerto Rico. Those States may have intentionally excluded their municipalities from Chapter 9, or they may have failed to enact the requisite specific authorization because they believed that their municipalities were permitted access to Chapter 9 under the pre-1994 requirement that a "general authorization" to petition for bankruptcy was sufficient. Either way, if one of its municipalities faces insolvency, any such State can overcome its inertia, enact the necessary legislation, and take advantage of Chapter 9. Unlike Puerto Rico, those States control their own access to debt adjustment. Their municipalities are not foreclosed from achieving the debt relief necessary to ensure the continued delivery of essential public goods or from forestalling the exodus of population and revenue shortfalls that inevitably accompany distress. Like States that have already adopted the requisite specific authorization for Chapter 9, those States neither directly nor virtually represent the interests of Puerto Rico in Congress.

This does not mean that Congress could not explicitly pre-empt a Puerto Rico territorial act.[6] But

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[6] Thus, the First Circuit's statement that "[i]f Puerto Rico could determine the availability of Chapter 9 for Puerto Rico municipalities, that might undermine Congress's ability to do so," 805 F.3d at 31, is simply incorrect. The First Circuit's citation of an article by Gillette, one of the authors of this

in the face of a Congress unmotivated to act by any constituency, the argument that technical ability to appeal to Congress is sufficient to avoid the dire consequences of municipal insolvency must be rejected. The constitutional and institutional differences between States and Puerto Rico suggest that, if anything, the argument for finding pre-emption *sub silentio* is even weaker with respect to the latter than it is with respect to States.

CONCLUSION

For the foregoing reasons, this Court should reverse the judgment.

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amicus brief, for that point is inapposite. Gillette's argument was that a municipality might frustrate a State's effort to address municipal fiscal distress by exploiting federal bankruptcy law, over which the State has no control. But that argument is irrelevant to Puerto Rico's enactment of a debt adjustment plan. Puerto Rico cannot strategically outflank Congress because Congress could, if it desired, expressly pre-empt Puerto Rico's ability to enact such a plan. To date, Congress has not done so.